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POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

WMB-T-1

RATE AND SERVICE CHANGES TO IMPLEMENT BASELINE NEGOTIATED SERVICE AGREEMENT WITH WASHINGTON MUTUAL BANK

Docket No. MC2006-3

DIRECT TESTIMONY OF MICHAEL RAPAPORT ON BEHALF OF WASHINGTON MUTUAL BANK

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AUTOBIOGRAPHICAL SKETCH

My name is Michael Rapaport. I manage the Marketing Services Group for Washington Mutual Bank's Credit Card business ("Card Services"). My group's responsibility includes direct marketing campaign execution and marketing analysis. I have been in my current role for 3 years. Prior to that, I spent 14 years at Fair, Isaac and Company in a variety of roles including developing some of the earliest FICO scoring models and ultimately managing the FICO Score line of business for North America. (The FICO Score is used by most lenders to determine a consumer's creditworthiness prior to granting additional credit). I graduated from Stanford University with a degree in Mathematical and Computational Sciences.

I. PURPOSE AND SCOPE

The Postal Service and Washington Mutual Bank ("WMB") have entered into a baseline Negotiated Service Agreement ("NSA") with respect to WMB's Card Services, which is now the subject of this proceeding. My testimony will provide a brief history of WMB Card Services, explain Card Services' approach to marketing, its use of Standard Mail and First-Class Mail and demonstrate why the NSA will encourage Card Services to shift its usage from Standard Mail to First-Class Mail. My testimony will also provide information on Card Services' address hygiene practices and return mail volumes.

II. HISTORY OF WMB CARD SERVICES

WMB Card Services was created on October 1, 2005 when Washington Mutual, Inc. successfully completed its acquisition of Providian Financial Corporation ("Providian"). At the time of its acquisition, Providian was the eighth largest card issuer with 9.7 million customers and $20 billion in managed credit card receivables. After its acquisition, Washington Mutual established the Card Services group as its fourth business line in addition to Retail Banking and Financial Services, Home Loans and Commercial Banking. The proposed NSA applies only to WMB's Card Services business.

III. WMB CARD SERVICES' MAIL TYPES

While WMB's other three business lines use multiple marketing channels including television, radio and print advertisements, WMB Card Services relies virtually exclusively on direct mail and telemarketing to promote its business. Like other card issuers, WMB Card Services mail types can be generally divided into two (2) kinds of mail: operational mail and marketing mail. Operational mail usually includes periodic statements, communications with customers regarding their card account and mailings of new or replacement cards. Marketing mail generally includes marketing materials designed to attract new customers or encourage existing customers to utilize their credit card and related products and services. While operational mail is sent using First-Class Mail, marketing mail may be sent via either Standard Mail or First-Class Mail.

IV. FIRST-CLASS MAIL AND STANDARD MAIL VOLUME HISTORY

As shown in Table 1 below, WMB Card Services' total mail volumes have stabilized after a rebound in mail volumes from 2003 to 2004 (which this section explains). WMB Card Services' total mail volume grew from 410 million pieces in 2003 to 533 million pieces in 2004 and 547 million pieces in 2005.[1] The increase in total volume from 2003 to 2004 was largely a result of the success of Providian's restructuring efforts which commenced in 2001. As recently as the first calendar quarter of 2003, Providian experienced a 17% charge-off rate which directly impacted mail volumes by: 1) reducing the total number of active accounts; 2) reducing the total marketing budget; 3) requiring significant portfolio sales, which also reduced the number of active accounts; and 4) yielding regulatory limitations on the types of customers to whom Providian could solicit. Also, as part of the restructuring, Providian developed a new marketing strategy, testing of which began in the second half of 2002, and was fully rolled out throughout 2003. By 2004, Providian's "turnaround" was largely successful and the company's new marketing strategy was fully implemented with an increased budget allowing total mail volume to increase from 410 million in 2003 to approximately 530 million in 2004. Table 1 summarizes the Historical Mail Volumes.

Table 1: Historical Mail Volumes (in millions)

Mail Class/Type	2003	2004	2005*
First-Class Mail	**393**	**352**	**402**
Operational	118	119	123
Marketing	275	233	279
Standard Mail Solicitations	**17**	**181**	**145**
Total Mail Volume	**410**	**533**	**547**

*Card Services is in the process of reviewing its actual mail volumes for the fourth quarter of 2005. Thus, for purposes of this table, I have accepted USPS estimates of Card Services' 2005 volumes. Our internal volume estimates, which are based upon a combination of actual and projected volumes, are 394 million First-Class Mail pieces and 132 million Standard Mail pieces.

[1] Note that these historical volumes and those in Table 1 do not include a small amount of Standard Mail fulfillment volumes (an average of about 3 million pieces per year) because they would be unaffected by the NSA.

V. FIRST-CLASS MAIL AND STANDARD MAIL VOLUME FORECASTS

To understand how WMB Card Services arrived at its volume forecasts for the 3 years of the proposed NSA, some background into the Marketing Strategic Planning Process may be useful. Next, I will discuss the methodology we employed to determine our forecasts, and more specifically, to demonstrate the cost-effectiveness of the proposed NSA.

WMB Card Services' process begins by establishing yearly account goals consistent with the business' strategic growth targets. With account goals established, we determine a marketing budget by estimating the costs to acquire an account. Factors which affect these 'account acquisition costs' include competitive pressure, an economic downturn or higher solicitation costs, all of which increase the acquisition costs, and improved response models, new market expansion or lower solicitation costs, which may reduce the acquisition costs.

During the year, WMB Card Services monitors its performance with respect to its account goals. Should account acquisition costs change, Card Services re-optimizes its mail strategy within the same budgetary constraint. Thus, if the account acquisition costs increase such that the established marketing budget is no longer adequate to obtain the account goal, Card Services will reallocate its spending among marketing campaigns most likely to achieve meaningful results. If account acquisition costs decrease such that unused marketing budget is available, Card Services will consider investing the additional spend in development efforts such as testing.

Based on our analysis of past response and booking rates as well as the competitive environment, to meet our account goals for Year 1 (2006) acquisition efforts, Card Services estimates that we would mail a total of 564 million acquisition mail pieces using a combination of Standard Mail and First-Class Mail. Next, to forecast the mail class mix, we used the mail class mix from the last two (2) quarters of 2005 (58% First-Class, 42% Standard) and applied it to this estimated total volume to determine mail class volumes for 2006 (327.1 million First-Class, 236.9 Standard), as shown in Table 2.

Next, Card Services assumed a 5.4 percent postal increase for all mail classes, beginning in January, 2006. To cover the increased postal costs, we would either have to reduce our total mail volume or shift volume to Standard Mail from First-Class Mail and our strategy is to perform the latter. Therefore, in order to keep mail volumes constant without additional marketing budget, Card Services shifted more than 20% of the First-Class volume to Standard, thereby reducing the First-Class volume to 250 million mail pieces, as shown in Table 2. Additionally, in 2006, the use of First-Class Mail for acquisition mail is expected to be heavier in the first half of the year, and as marketing budget is expended, Standard Mail volumes are expected to increase.

Table 2: Year 1 Acquisition Mail Volumes

Acquisition Mail Volumes	Total	Standard	First
Baseline Acq Mail	564,000,000	236,880,000	327,120,000
Mix Adj.- Postal Increase	564,000,000	314,000,000	**250,000,000**

*The figures in this table do not include solicitation mail pieces sent to existing customers. These 80 million pieces are included in Table 3 below.

Our operational mail volumes and the volume of marketing mail that we send to our cardholders are also a result of our account goals. Given our account goals, we expect 2006 operational and customer solicitation volumes to be similar to 2005 volumes.

To determine Before Rates volumes for Years 2 and 3 of the proposed NSA, Card Services assumed that volumes would grow by approximately five (5) percent annually.[2] This assumption was driven by 2 factors: 1) internal projections forecasting account growth of five (5) percent per year for each of Year 2 and Year 3; and 2) expectation of higher acquisition costs per account due to increased marketplace competition and "list fatigue" which occurs when the same prospects are mailed repeatedly without any development efforts, resulting in lower response rates over time. Table 3 shows the Card Services' three (3) volume forecasts without the rate discount provided by the NSA.

<u>Table 3: Mail Volume Forecasts (Before Rates)</u>

Mail Class/Type	Year 1	Year 2	Year 3
First-Class Mail	**450**	**475**	**500**
Operational	120	125	130
Marketing	330	350	370
Standard Mail Solicitations	**314**	**330**	**345**
Total Mail Volume	**764**	**805**	**845**

VI. AFTER RATES VOLUME AND THE IMPACT OF THE NSA

Card Services expects that the NSA will cause it to mail virtually all, if not all, of its solicitations as First-Class Mail. As discussed in Section V, at current rates, it is cost effective to mail a significant portion of our acquisition mail as Standard Mail. This is because, for much of our acquisition mail, the lift (i.e., the higher response rate) from using First-Class Mail rather than Standard Mail does not justify the average ten-cent higher First-Class Mail postage.

[2] Note that, after increasing the volumes by five percent annually, Years 2 and 3 volumes were rounded to the nearest five or ten million pieces as deemed appropriate.

We performed a breakeven analysis using our targeting engine. The targeting engine found that reducing the postage difference between First-Class Mail and Standard Mail to six cents (a four-cent reduction) would justify switching all of our acquisition mail to First-Class Mail. Our targeting engine found that at a four-cent discount (the "breakeven discount"), the response rate lift from using First-Class Mail (nearly 20 percent) offsets the higher First-Class Mail postage cost. At the breakeven discount and assuming a constant budget, Card Services would mail less acquisition mail pieces (approximately 84 pieces of First-Class Mail would replace every 100 pieces of Standard Mail), but the lift from using First-Class Mail would allow us to acquire the same number of customers.

The response rate lift from using First-Class Mail is the result of two different sources. First, as mentioned above, consumers simply respond more to First-Class Mail than to Standard Mail. Second, sending a smaller volume of First-Class Mail (than if the acquisitions were sent as Standard Mail) allows us to mail only to the better prospects on our list.

Applying this analysis to the NSA, the discounts (which average slightly more than four cents per incremental piece of First-Class Mail) will cause WMB to replace 314 million Before Rates Standard Mail pieces with 263 million First-Class Mail pieces in Year 1. As shown in Table 4, similar shifts would occur in Years 2 and 3.

The NSA would also produce a secondary effect on Card Services acquisition mail volumes. Card Services plans to reinvest the discount above four cents in additional acquisition First-Class Mail. Table 4 summarizes Card Services' After Rates forecasts. Exhibit A attached hereto provides additional details.

Table 4: Mail Volume Forecasts (After Rates)

Mail Class/Type	Year 1	Year 2	Year 3
First-Class Mail	**713**	**750**	**785**
Operational	120	125	130
Marketing	593	625	655
Standard Mail Solicitations	**0**	**0**	**0**
Total Mail Volume	**713**	**750**	**785**

VII. CAPPING DISCOUNTS AT COST SAVINGS IS NOT ECONOMICALLY VIABLE

As discussed above, I fully expect that the NSA discounts will induce Card Services to mail all of its solicitations as First-Class Mail. This will increase our First-Class Mail volumes by 250 to 300 million pieces per year and thereby significantly increase the contribution of our mail to Postal Service institutional costs.

We are aware that the Commission has conditioned approval of previous NSAs on the imposition of a cap on the total amount of the discounts. However, those NSAs were functionally equivalent to the Capital One NSA. Our NSA is not. This is a baseline agreement that depends on its own internal values and economics, and not on the fact that it is like some previously approved NSA.

In this case, capping discounts at cost savings will significantly reduce, if not entirely eliminate, the increased contribution. To induce the desired change in behavior, the Postal Service will need to offer Card Services postal discounts in excess of $10 million per year. I understand from the Postal Service that a cost savings cap would be about $10 million over the entire three-year duration of the NSA. Thus, the NSA discounts would be exhausted one year into the deal. Once the cap on discounts is reached, WMB Card Services would revert to its lower-contribution “Before Rates” mailing patterns. This is because once the cap is reached and WMB is ineligible for additional NSA discounts, First-Class Mail postage will again be about ten cents higher than Standard Mail postage. As discussed in Section VI, for much of our acquisition mail, the lift from using First-Class Mail does not justify the ten-cent higher postage cost.

Further, since the NSA as negotiated just exceeds breakeven for WMB Card Services, I believe that implementing the agreement's requirements would not be economically justifiable if Card Services only received postage discounts for a year. Given this, if the Commission imposes a cap of approximately $10 million on postage discounts, the economic rationale for WMB Card Services' participation in the NSA would be lost. This would be unfortunate because I believe the NSA as executed benefits both parties.

VIII. ADDRESS HYGIENE AND RETURN MAIL VOLUMES

As required under the NSA, Washington Mutual will continue its practice of only using addresses that have been processed against National Change of Address / Coding Accuracy Support System databases within the 90 days prior to mailing. Based upon this practice, our recent return rates were approximately 1 percent for operational mail and 4.5 percent for marketing mail.[3] Also, as part of the agreement, WMB Card Services has agreed to update its databases for soliciting non-cardholders using ACS data. While using ACS data could reduce our return rate, thereby reducing Postal Service costs and increasing the value of the agreement to the Postal Service, I conservatively estimate that our return rates for the duration of the NSA will be similar to our recent return rates. While these requirements have value to the Service, the principal value of the NSA to USPS is the significant increase in First-Class Mail volumes and net contribution to institutional costs.

[3] These return rates were calculated using 2005 data for acquisition mail and 2003-2004 data for mail (including operational and marketing pieces) sent to existing customers.

CONCLUSION

The proposed NSA creates strong economic incentives to Card Services to redirect Standard Mail volume to First-Class Mail. We are not asking the Commission to approve this NSA because of the incidental cost savings that are part of the deal; rather, this NSA is a baseline agreement; it is not functionally equivalent to previous agreements; and it should be judged on its own merits. We believe that the volume projections before- and after-rates are quite realistic and, because of that, should mitigate concerns about potential losses to the Postal Service. In the deals struck in previous NSAs, where caps were imposed in order to limit potential losses to the Postal Service, the cap still permitted the agreements to have economic viability for the partners. That is not the case here. This deal will not work for Card Services if the amount of the discounts is capped so that no discounts are available in Years 2 and 3. As we testify, that would kill this deal for Card Services. There would be no economic incentive to convert Standard Mail to First-Class and, therefore, there would be a reversion to the *status quo ante,* and a very large conversion of First-Class Mail to Standard Mail in Years 2 and 3. That makes no sense for Card Services and it certainly would make no sense for the Postal Service. We urge the Commission to approve the deal that we made.

Exhibit A. Calculation of After-Rates First-Class Mail Volume (in Millions)

Year	Before Rates Volume			Migration From Standard to First-Class Mail			Reinvestment of Benefit		After-Rates
	Total	First-Class	Standard	Incr. FCM Vol	Total Discount	Discount/Pc	Benefit	Incr. FCM Vol	FCM Volume
	[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]
Year 1	764	450	314	263	$10.7	$0.041	$0.2	0.4	713
Year 2	805	475	330	274	$11.4	$0.041	$0.4	1.1	750
Year 3	845	500	345	283	$11.9	$0.042	$0.6	1.5	785

[1],[2],[3] WMB-T-1, Table 3
[3] All of these pieces are acquisition mailpieces.
[4] Approximate number of acquisition First-Class Mail pieces required to obtain the same number of responses as the Standard Mail pieces in [3]. Further, with 4-cent discount, these First-Class Mail acquisition pieces can be mailed at about the same total cost as the Standard Mail pieces in [3].
[5] NSA discount for mailing combined First-Class Mail volume in [2] and [4]. (Calculated assuming 5% per year increase in the volume threshold.)
[6]=[5]/[4]
[7]=[4]*([6]-$0.04)
[8] Approximate First-Class Mail volume that can be sent with "benefit" in [7].
[9]=[2]+[4]+[8]
Note: To protect confidentiality, numbers in this exhibit are approximations.